

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 98-0328 IT
Adjusted Gross Income Tax — Nonbusiness Income
For Tax Period: 1993

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ISSUES

I. Adjusted Gross Income Tax — Nonbusiness Income

Authority: IC 6-3-1-20
45 IAC 3.1-1-29

Taxpayer protests Audit's characterization of taxpayer's mortgage debt reduction as business income.

STATEMENT OF FACTS

Taxpayer, a New York corporation, manufactures and sells wall plaques and mirrors. Taxpayer engages in retail business activities primarily during the holiday season - from November 1 through December 31. Additionally, taxpayer operates, year round, a wholesale business where it sells its products to gift shops. Taxpayer's Indiana activities are limited to the operation of pushcarts and kiosks at two shopping malls.

At issue is the classification of income resulting from a mortgage debt reduction. Taxpayer classifies this income as nonbusiness; Audit calls it business.

I. Adjusted Gross Income Tax — Nonbusiness Income

DISCUSSION

Taxpayer protests Audit's characterization of income from a mortgage debt reduction on taxpayer's corporate headquarters as "business income" – income subject to Indiana apportionment for adjusted gross income tax purposes.

Taxpayer realized a gain when the bank holding the mortgage on taxpayer's corporate headquarters (Bank A) declared bankruptcy. As a result, the Federal Deposit Insurance Corporation (FDIC) took over taxpayer's mortgage until it could be placed with another lender. Meanwhile, taxpayer continued to make mortgage payments to the FDIC.

Taxpayer, and the FDIC, had difficulty placing this loan with another lender. Eventually, taxpayer was able to obtain a new mortgage from another bank (Bank B). Because of a decline in real estate values, the new mortgage issued by Bank B was for an amount less than the balance remaining on the original mortgage. The FDIC absorbed the difference - \$567,988 - which, for taxpayer, represented the amount of debt forgiveness. Taxpayer subsequently characterized this debt forgiveness as "other income" on its federal returns.

Taxpayer argues the mortgage debt forgiveness should be classified as "nonbusiness income." Taxpayer reasons that since its principle business does not include investments in real estate, income derived from this transaction - i.e., mortgage debt forgiveness on corporate headquarters - should not be classified as business income. Rather, consistent with Indiana statutory and regulatory language, the receipts from this transaction should be classified as nonbusiness income. And nonbusiness income, of course, cannot be apportioned to Indiana.

The foundation upon which taxpayer's argument rests is 45 IAC 3.1-1-29, which defines business income. The salient portion reads:

Income of any type or class and from any source is business income if it arises from transactions and activities occurring in the regular course of a trade or business. *Accordingly, the critical element in determining whether income is 'business income' or 'non-business income' is the identification of the transactions and activity which are the elements of a particular trade or business.* (Emphasis added.)

Taxpayer concludes - from a reading of both Indiana statutory (IC 6-3-1-20) and regulatory (45 IAC 3.1-1-29) language - the Department cannot properly classify, as business income, this mortgage debt reduction.

Audit, however, has characterized taxpayer's mortgage debt reduction as "business" income. Audit reasons that since the property mortgaged - i.e., corporate headquarters - was used in taxpayer's trade or business, the income received should be classified as business income subject to Indiana apportionment.

The statutory definition of business income is found in IC 6-3-1-20, which provides:

The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.

Taxpayer's business consists of manufacturing, retailing, and wholesaling wall plaques and mirrors. Taxpayer is not in the business of acquiring and disposing debt instruments - in this case, mortgages. Additionally, this transaction does not involve the "acquisition, management, *and disposition*" of a business-related, income producing asset. Rather, this transaction, which resulted in a mortgage debt reduction, was precipitated by the bankruptcy of the holder of taxpayer's mortgage - an exceptional event not related to taxpayer's regular business activities.

Since this transaction does not represent an activity that is part of taxpayer's regular trade or business, and does not involve the disposition of a business-related asset, the Department finds that taxpayer's mortgage debt reduction should be classified as nonbusiness income.

FINDING

Taxpayer's protest is sustained.